PART ONE

CHAPTER 1

The Real Estate Market Has Crashed

Pick a city in the United States: Boston, New York, Atlanta, Miami, Dallas, Chicago, Denver, Los Vegas, Phoenix, San Diego, Los Angeles, San Francisco, Portland, or Seattle. Everywhere in the country the real estate market is crashing—just as it is in other regions around the world. Prices in all 20 major metropolitan areas in the United States measured by the S&P/Case-Shiller Home Price Index are spiraling downward. Nationwide the index plunged 19.1 percent in the last year.

In 2008, in the United States alone, 3,000,000 homeowners received foreclosure filings on their homes. This represents 1 in 54 homes in the United States. According to a national foreclosure list company, more than 860,000 properties were repossessed by lenders last year. Many hundreds of thousands more were bought by real estate investors through short-sales or at the foreclosure auction. In the first six weeks of 2009, foreclosure proceedings began on another 296,000 homeowners according to the Center for Responsible Lending (a nonprofit organization focused on eradicating predatory lending practices).

At least 10 to 12 million households are facing foreclosure over the next four years. In the current economic downturn, 7 million to 8 million people could lose their jobs. They will not be able to make their mortgage payments. January 2009 foreclosure filings were up 18 percent from January 2008. Again, according to a national foreclosure list company 1 in every 466 households nationally received a foreclosure notice in January 2009.

Moody's Economy.com says that 13.8 million of the 52 million United States homeowners with a mortgage (27 percent) owe more on their mortgages than their homes are worth. This is what is known as being *underwater* with your mortgage.

Bank repossession rose 184 percent year-over-year. According to the National Association of Realtors (NAR) in the United States, 19 percent of the inventory of existing homes for sale in January 2009 was bank real estate-owned (REO) properties. This creates a huge downward pull on real estate prices. The median price of a single-family home in the United States was $175,400 in December 2008 down 15.3 percent from a year ago. What happened to the housing boom?

Financial Derivatives Have Crashed the Real Estate Market

Financial derivatives have crashed the real estate market worldwide. A financial derivative is a contract between a buyer and a seller that derives value based on an underlying asset like a stock or a real estate mortgage. Poor quality mortgages were the underlying assets for trillions of dollars in high-cost derivatives. How did this happen?

A poor quality mortgage occurs when a borrower stops making monthly payments. Media attention has been focused on the subprime mortgage borrower. These were borrowers who were not qualified for A paper or prime mortgage loans. Banks loaned them money based on these borrowers' ability to breathe on a mirror and fog it up. These loans could be characterized as B, C, or D paper.

However, many borrowers of A paper and Alternative A (Alt A) paper have stopped making their mortgage payments, too. Alt A mortgages were given to borrowers who may have had good credit but had no long-term ability to make monthly mortgage payments. These were a version of NINJA loans. A NINJA loan means No Income, No Job, and (No) Assets.

Adjustable Rate Mortgages

Many A paper and Alternative A (Alt A) paper borrowers' inability to continue making monthly mortgage payments were exacerbated when the mortgage came with an adjustable interest rate and/or adjustable monthly payment. After the initial teaser rate with its correspondingly low payment changed with the first rate adjustment triggering higher monthly payments, these borrowers could not afford to make their monthly mortgage payments.

Added to this banking debacle was the normal cyclical nature of the real estate market. Just as the top of the real estate cycle was being hit and a normal price leveling or price decline was occurring, the rates and payments on millions of real estate loans were adjusting upward.

Savings and Loan Crisis

In the 1980s, the United States experienced a crisis in the savings and loan industry. Cheap credit, nonexistent lending standards, and weak government regulation caused hundreds of savings and loan institutions to fail. Today, we have those same three factors at work plus two new ones.

The first new factor is that banking is no longer local. Banking is now global. Look what happened to the country of Iceland when its banks went under. The government collapsed. The second new factor is the packaging of mortgage debt into securities (derivatives) beyond the control of any government regulation.

From 1995 to 2005, Bank of America, JPMorgan Chase, and Citigroup became international players buying and selling stocks and bonds and managing assets such as mortgage-backed securities for big fees. This has been referred to as the universal bank model.

Acting Locally and Globally

These big banks were acting locally and globally. From 1995 to 2008, bank branches in the United States went from 81,000 to 99,000. This was a 22 percent increase. First-time home buyers and people wanting to pull equity out of their homes were encouraged to come in and borrow money. Unscrupulous mortgage brokers aggressively pursued predatory lending practices in order to maximize their profits.

In one of the most egregious cases of predatory lending practices discovered so far, Ray Vargas of Cerritos, California, was hit with unconscionable lending fess, prepayment penalties, and interest charges. An investigation by msnbc.com showed that in a "21-month period in 2005 and 2006, Vargas' home was refinanced five times through a total of six loans."

According to msnbc.com his loan total went from $213,555 to $745,000. To access this $531,445 in equity Mr. Vargas "paid at least $123,237 in loan origination fess and prepayment penalties," according to the report. He paid another $60,000 in interest. This occurred as he was coping with the death of his wife of 57 years and her huge medical and nursing home bills. By the way, Mr. Vargas is 84. So what did the banks do with all these new loans?

Bundling

The banks then bundled together trillions of dollars of these mortgages and sold them to investors all around the world. Mortgages on properties in California, Nevada, Florida, or Rhode Island would become the underlying assets to financial derivatives sold to hedge funds in Paris, London, Singapore, or Shanghai.

In the past, credit had been extended based on the borrower's ability to repay the loan. Now credit was being extended based on the lender's ability to package a mortgage loan as a security instrument and sell it. Mortgage borrowers like Ray Vargas were just a means to an end. The big investment banks like Lehman Brothers, Merrill Lynch, Morgan Stanley, and Goldman Sachs saw how much money was being made and jumped into the game.

Wall Street Took over Main Street

Wall Street took over Main Street. These firms bought and sold mortgage-backed securities by borrowing astronomical amounts of money. In 2006, Goldman Sachs made a $9.4 billion profit, which was the highest in Wall Street history. Morgan Stanley made a profit of $7.1 billion. Their respective CEOs were paid bonuses of $53.4 million and $41.4 million.

Then toward the end of 2006 the housing market began to cool off. Subprime loans were the first to implode. This was the beginning of the end. During 2007 and 2008, all the players involved experienced massive losses, as many borrowers in all types of mortgage categories stopped making their mortgage payments for various reasons. Banks now have $5 trillion in nonperforming assets (potential losses) crushing their balance sheets.

AIG (American International Group)

AIG made a fortune selling insurance contracts to banks and hedge funds guaranteeing the value of the derivative contracts. By the fall of 2008, the United States Federal Reserve made the decision to rescue AIG. One hundred and fifty billion dollars later and the company that we have been told is too big to be allowed to fail is still failing. Without the government rescue the whole banking system would have collapsed under the domino effect because no bank's assets were worth the paper they were written on.

One portfolio of AIG assets the Federal Reserve holds is valued at $20 billion of residential mortgage-backed securities. A second portfolio is valued at $27 billion and consists of collateralized debt obligations, which are financial derivatives that combine slices of debt. These investment portfolios are made up of billions of dollars of toxic paper. Sorting out the toxic paper from the nontoxic paper is just one of the problems.

Financial Derivatives Are the Solution

However, noted expert and professor of economics at Yale University, Robert Shiller believes that financial derivatives are the solution to the current financial crisis. Financial derivatives are a risk management tool according to Shiller. He equates them to an insurance policy. "You pay a premium and if an event happens, you get a payment," says Shiller.

Robert Shiller is the Shiller of the S&P/Case-Shiller Home Price Index. Movement in this index can be traded on the Chicago Mercantile Exchange.

Shiller wants homeowners and lenders to be able to insure themselves against falling housing prices. He proposes doing this by using a version of a financial derivative. Let's look at an example.

Example

You buy a home for $350,000. You make a 20 percent down payment of $70,000. You borrow $280,000 from your mortgage lender.

Home Purchase

Purchase price	$350,000
Down payment	−$ 70,000
Mortgage amount	$280,000

You buy a derivative that is inversely related to the nearest regional S&P/Case-Shiller Home Price Index to your property. If the value of your property drops and by extension the Home Price Index drops, the financial derivative would go up in value and offset your loss.

Let's say the value of your home drops 30 percent or $105,000 because of changing market conditions. Now your home is worth $245,000.

Home Value Drops

Property value	$350,000
Loss in value	−$105,000
New property value	$245,000

You are effectively underwater with your mortgage of $280,000 being $35,000 greater than the value of your property.

Underwater

Mortgage amount	$280,000
New property value	−$245,000
Underwater	$ 35,000

Your financial derivative would go up in value from 0 to $105,000.

This would recoup your $70,000 down payment and your $35,000 underwater amount.

Derivative Value

Down payment	$ 70,000
Underwater amount	+$ 35,000
Derivative value	$105,000

Lenders Use Derivatives Locally not Globally

Lenders could do the same thing as their borrowers. By buying a derivative, the lender would have a hedge against having to foreclose and likely winding up owning property the lender is not interested in owning. If a borrower stopped paying on a mortgage loan the derivative would cure the deficiency.

It would also protect the lender from having to do a short-sale. A short-sale would require the lender to cram down the loan amount from $280,000 to $245,000 in order for the property to sell at the current market value. This would result in at least a $35,000 loss to the lender.

Lender Loss

Mortgage amount	$280,000
Cram down amount	−$245,000
Lender loss	$ 35,000

$20 Trillion Housing Market

By having derivatives available for borrowers and lenders, the $20 trillion housing market can become more liquid. Without derivatives there are very limited ways to unlock profit when the market falls. The stock market allows options and derivatives. This allows money to be made even when the market is falling.

This significantly increases the number of buyers and sellers in the stock market. More buyers and more sellers mean more liquidity. More liquidity means a better functioning market even in turbulent conditions.

History

In the 1920s, U.S. mortgage lending was a very simple financial transaction. If you wanted to borrow money to buy a home you went to your local bank. The bank gave you the money to buy your home and you gave the bank a promissory note and a mortgage contract.

The promissory note was the evidence of your debt to your bank. The mortgage contract was the security device that gave the bank the legal right to foreclose on your ownership title in the event you defaulted on your monthly payments.

The bank got the money to loan to you by borrowing it from all the depositors who put money in the bank. In return for putting money in the bank, the bank gave each depositor a passbook showing how much money they had on deposit. The bank also paid a small amount of interest to encourage people to take their money out of their coffee cans and mattresses and bring it to the bank.

The banks made money on the interest rate spread between what they were paying their depositors and what they were being paid by their mortgage borrowers. If a bank was paying 1 percent to its depositors and receiving 4 percent from its mortgage borrowers, the interest rate spread was 3 percent. This is what is known as the primary mortgage market.

Primary Mortgage Market

The primary mortgage market is a financial transaction between the bank and a mortgage borrower. The money went from the bank to the borrower. The promissory note and mortgage contract went from the borrower to the bank.

Primary Mortgage Market

Money →

Bank Borrower

← Paper

In other words, the money went in one direction and the paper went in the other direction. This system worked well until the stock market in the United States crashed and the depression of the 1930s ensued.

Recession, Depression, Panic

Let's be clear. Today we talk about a contraction of the economy as a recession. The word is not even capitalized so as to downplay what is really going on in the economy. A recession is defined as two consecutive quarters of negative economic growth as measured by the gross domestic product (GDP).

Recessions used to be called depressions. However, politically the word depression is too unpalatable a term. So in the modern era we have sugarcoated economic difficulty with a word that sounds like something you looked forward to in grade school: recess-ion.

The United States in the 1870s had banking panics. By the 1930s the political powers that be substituted the word depression for panic. Talking about an economic depression had a much milder emotional impact than talking about an economic panic. It also allowed politicians to get reelected.

Crisis of Confidence

The reality of the 1930s was another banking panic. People wanted the banks to give them back their cash when the economy got into trouble. All the depositors showed up at the same time and said, "Here is my passbook. Give me my money." But the banks could not comply.

The banks had loaned out the money for people to buy real estate. The banks had very little cash because they were holding the mortgage papers. This is called a run on the bank. Thousands of banks failed. Millions of Americans lost all their money.

History Repeats Itself

History is now repeating itself. According to RBC Capital Markets, 1,000 banks will fail in 2009 and 2010. In July 2008, we had the run on IndyMac Bank. This was a national banking conglomerate with $32 billion of assets. Unfortunately, many billions of these assets were toxic. The bank was rocked by losses on defaulted mortgages made at the top of the housing boom.

In September 2008, Washington Mutual was seized by the United States government. Over a 10-day period $16.4 billion in deposits was withdrawn from the bank by panicked customers. Before it collapsed Washington Mutual was the sixth largest bank in the country. It held more than $327 billion in assets. This was 10 times the amount of assets held by IndyMac Bank. It was the largest bank failure ever. Perhaps we should say so far.

Fannie Mae

In response to the collapse of the primary mortgage market in the 1930s because of the lack of liquidity in the system, the United States federal government created the Federal National Mortgage Association or Fannie Mae in 1938. The purpose of Fannie Mae was to create a secondary mortgage market and prevent banking panics.

Secondary Mortgage Market

The mortgage paper would be passed from the bank to Fannie Mae. In return, Fannie Mae would send money to the bank. That way, when the depositors showed up with their passbooks and said, "Give me my money," the bank actually had the cash to give them.

Secondary Mortgage Market

	Money→	
Fannie Mae		Bank
	← Paper	

The bank went from being the owner of the mortgage paper to being the servicing agent for Fannie Mae and receiving a fee for collecting the mortgage payments from the borrower.

The secondary mortgage market system was expanded in 1968 and again in 1970. In 1968, Fannie Mae acquired a sister, Ginnie Mae, the Government National Mortgage Association. The Federal Home Loan Mortgage Corporation, Freddie Mac, was added in 1970.

What most people do not know is that Fannie Mae was privatized in 1968 to remove its activities from the federal budget. Freddie Mac has been privately owned since its inception. Even though they both had the word federal in their names, neither company was federal until the federal government took them over in the last quarter of 2008. Now they are both "federalized."

Today

Today there are $10.5 trillion in mortgages in the United States according to the Federal Reserve. More than 90 percent of these mortgages are now owned by someone other than the bank that made the loan in the primary mortgage market.

Fannie Mae and Freddie Mac got into trouble because they packaged and sold mortgage-backed securities. Fannie and Freddie wanted more liquidity and profits so they created a tertiary mortgage market. They sold the mortgage-backed securities to hedge funds in return for big cash profits.

Tertiary Mortgage Market

	Money→	
Hedge funds		Fannie/Freddie
	←Paper	

This tertiary mortgage market was a global market. It was a giant Ponzi scheme played out on the global stage in trillions of dollars. As long as everyone was making big fees packaging and servicing these securities, then everything was hunky-dory-copasetic-peachy-keen.

In fact, it was impossible to determine the value of the securities Fannie Mae and Freddie Mac were selling. That is still the problem today. No one can figure out how to separate the toxic securities from the nontoxic securities.

Once the housing market cooled in the United States and people stopped making payments on their mortgages, the cash flow that drove this whole system dried up. One part of the United States government bailout was the immediate cash infusion of $66 billion in combined subsidies to Fannie Mae and Freddie Mac.

The Impasse

So far the solution to this mortgage mess has remained at an impasse. The impasse was described quite succinctly by Steve Preston, a former housing secretary in the Bush administration:

> *We still have somewhat of an impasse between the people who are sending you your mortgage bills, your (loan) servicers, and people who own your mortgages. That's an impasse we have to break."*
>
> (Feb. 10, 2009)

The loan servicing companies act as the go-between to collect payments from homeowners and distribute them to investors. They have behaved with tortoise-like speed to loan modification requests from homeowners. Their position is based on the liability they have to investors like Fannie Mae and Freddie Mac should they modify a loan without these investors' approval; they are afraid of being sued by these investors.

Hope for Homeowners

The United States Congress passed the Hope for Homeowners program, which was to run from October 1, 2008 to September 30, 2011. The goal of the program was to help at least 400,000 homeowners modify or refinance their potentially foreclosure-causing adjustable rate mortgages into 30-year fixed-rate loans. This program has been an abysmal failure. Unrealistic restrictions and exorbitantly high fees allowed only 25 homeowners to be approved by the end of 2008.

New Programs

Under a new program created by Federal Deposit Insurance Corporation (FDIC), guidelines were developed to accelerate the modification of mortgages held by the failed IndyMac Bank. This program would provide financial incentives to loan servicers to modify loans and give them legal protection from investor lawsuits if they follow certain guidelines. This program became the template adopted by the Obama administration to rescue the real estate market.

Homeowner Stability Initiative

The Obama administration wants to stop the 10 million to 12 million foreclosures that are projected to happen over the first and what would be the only four-year term for President Obama if nothing is done. The Obama plan would keep 4 to 5 million homeowners in their homes.

Under the Homeowner Stability Initiative, the government would invest $75 billion to buy millions of mortgages that are in default or are about to go into default. Rather than paying par value, the mortgages would be bought at a discount.

Using our example from earlier in the chapter, the government would buy the $280,000 mortgage for the current market value of the property or no more than $245,000. This $35,000 cram down is a 12.5 percent discount.

Cram Down Percentage

$$\frac{\$35{,}000}{\$280{,}000} = 12.5$$

Of course, the government may want a bigger discount and force the lender to accept a bigger cram down on the loan payoff.

Refinance

The Homeowner Stability Initiative would then allow the homeowner to refinance the new loan amount at a lower interest rate and for a lower monthly payment thus preventing the homeowner from falling into foreclosure.

With the Treasury injecting another $200 billion into Fannie Mae and Freddie Mac, the secondary mortgage market would be revived. Mortgage lenders making new loans or refinancing existing loans would be able to pass the mortgage paper to Fannie Mae or Freddie Mac and receive the cash back to make more loans.

Two Questions

You should have at least two questions at this point. Your first question should be: "How can I feel comfortable investing in this crashing real estate market?" Your second question should be, assuming you decide to get involved: "How do I make money investing in a crashing real estate market?"

To answer your first question: We have just told you the U.S. federal government is going to get involved to the tune of at least $275 billion in this crashing real estate market. It is always a good thing to have substantial money partners involved in the market with you. That bodes well for the long-term health of the market.

The answer to the second question is what the rest of this book is about. Before you can make money investing in a crashing real estate market you have to have a strategy. In the next chapter we will talk about building a quick cash *and* a long-term wealth-building strategy.